Five questions for the Chief Investment Officer—August 2018

Video transcript

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Victoria Place (VP): Welcome to *Five questions for the CIO.* My name is Victoria Place and I'm an analyst in UniSuper's Investment team. I'm joined here by John Pearce, our Chief Investment Officer.

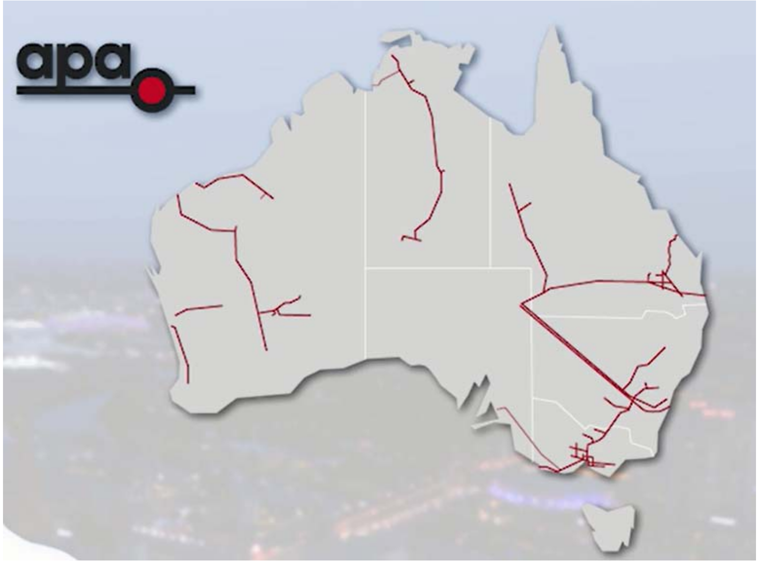
John, let's jump straight into politics and get your views on the impact the chaos in Canberra is likely to have on the economy and financial markets.

John Pearce (JP): We've gone 27 years without a recession. I don't think there'll be many people putting that down to political stability and great leadership. Generally speaking, I think the impact of politics on the economy and financial markets is exaggerated. If you look at the Australian share market, we're currently trading around 10-year highs, so the market is taking the current changes in its stride.

I am generalising there. There are some clear exceptions. For example, the energy sector—I'd imagine it would be pretty difficult contemplating large investments in a sector where you don't have a nationally coordinated policy.

VP: It looks like one of our largest investments, gas pipeline operator APA, is getting caught in the crosshairs of politics. Can you elaborate?

JP: It's an intriguing and rather complicated story, so let me try. APA—we've got about $1.8 billion invested in this company, so it is a very large investment. APA is the owner and operator of about 15,000 kilometres of gas pipelines all around Australia. So you can understand why we believe it's a classic 'fortress asset' and it's very suitable for many of our investment options.



What are the big developments? CKI, which is a Hong Kong company, has made a takeover offer of $11 per share for APA and that represented about a 30% premium to where the shares were trading at the time, so very healthy. The APA Board has recommended to shareholders that they accept the offer and we are happy with the Board's recommendation. We actually accumulated our shares at prices well below $11, so if this deal does get pulled off, we're making a lot of profit for our members.

That's the good news. There's always a twist to these sorts of deals—the twist here is that it is subject to regulatory approval. The competition regulator, the ACCC, has to approve it and also the Foreign Investment Review Board—so ultimately, Canberra. The share price is currently trading at around $9.70, which is well below $11, so the share market is basically saying, "Look, we've got real doubts that this deal is going to get pulled off." Why the doubts? CKI is a Hong Kong-based company. Politicians are saying, "A Hong Kong company is effectively influenced by the Chinese government and it's against our national interest to hand over control of such critical infrastructure to such a company."

I don't know how this is going to play out. There's speculation that there could be another bid, but as I said, it's speculation. Regardless of whether a deal gets done or not, APA is a fortress asset. We've accumulated the shares at attractive prices, so we're happy either way.

VP: Switching from Australian to global politics, it seems that Trump is intent on escalating the trade war with China. Is there a resolution in sight?

JP: Unfortunately not. What's the status so far? America has levied 25% tariffs on $50 billion of Chinese imports and the Chinese have retaliated in kind. Trump said he's prepared to keep going and he's fairly confident this is a battle that he can win. Why? Because the mathematics are on his side. America actually imports over $500 billion of Chinese goods and only exports about $130 billion.

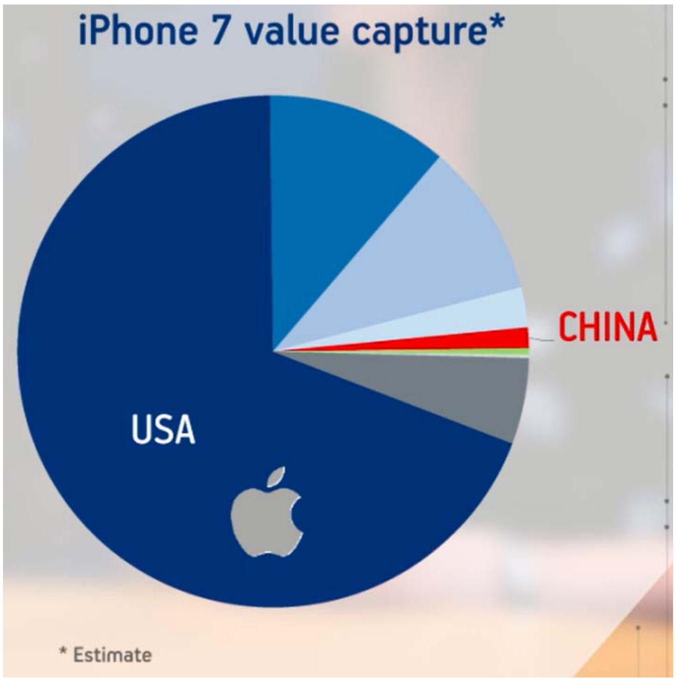
Trump's rationale is that, eventually, the Chinese will have to run out of firepower. Trump has actually said he's prepared to go the whole $500 billion. Let's hope that doesn't happen because it won't just be bad for China and America, it will be bad for the global economy. In fact, economists are already revising down estimates for global growth if indeed this war escalates.

The reason why it's bad for the global economy is because trade is fundamentally interconnected. Let's take the example of mobile phones. It turns out that mobiles phones are actually the largest export from China to the US, and obviously iPhones will be a significant component of that. If I asked you how many countries get involved in the manufacture of an iPhone, I bet you wouldn't guess it's actually 31 countries. If you look at [this] table, China actually has the most suppliers to an iPhone, so you think, ‘Well, this is actually hitting China’.


The “global” iPhone
(suppliers per country)

349	China	11	Vietnam	2	Brazil
139	Japan	7	Mexico	2	Costa rica
60	USA	6	Indonesia	2	Austria
42	Taiwan	6	Israel	2	Netherlands
32	South Korea	5	France	1	Canada
21	Malaysia	5	Czech Republic	1	Portugal
24	Philippines	3	Belgium	1	Spain
21	Thailand	3	Italy	1	Morocco
17	Singapore	3	Ireland	1	Puerto Rico
13	Germany	3	UK	1	Malta
				1	Hungry

But if you look at the value contribution of China, and where the money is actually made, China is only a small part of this because it's in the low-end manufacturing. Guess who makes the lion's share of profit from an iPhone? No prizes here—it's Apple, of course.



And here is the irony. The irony is that the biggest beneficiaries of free global trade are the American multinationals, so it's no surprise it’s the American multinationals who are pleading with Trump to back off. Trump says this is all about bringing jobs back to America but the US is at full employment. Lifting tariffs is only going to lift prices, so the American consumer will ultimately be worse off.

So this, to me, is as much about politics as it is about economics. Trump has to fight mid-term elections and getting tough with the Chinese seems to be a popular sort of strategy. I think that the only resolution here is when political expediency, rather than economic rationalism, demands that it gets solved.

VP: John, you mentioned that the Australian share market is trading around 10-year highs. What are the main drivers of this performance?

JP: We know what it's not. It's not our banking sector—which is our largest sector—which remains in the doldrums because of the Royal Commission. It's basically all of our companies that are leveraging solid global growth, and in particular, our resources industry. A couple of interviews back, I gave the examples of BHP and Rio, how their profits are increasing because they managed to lower their costs and increase their revenues with stronger commodity prices. Another big influence is a lower Australian dollar. A lower currency is actually supportive of companies and share prices in two main ways. I think it's worth exploring this a bit further.

Let's look at this from an American investor's perspective and bear in mind that about 40% of our market is actually owned by foreigners. Think of an American investor looking at BHP shares, which are currently trading around AUD$33. That equates to about USD$26.40 at an exchange rate of 80 cents. It was only in February of this year when our currency was trading at around 80 cents, so we're using that as an example. Roll the clock forward—let's assume that the currency then drops down to 72 cents and there's been no change to BHP as a company. Look what the shares are now costing that American investor: $23.76. No changes to the company, yet the share price is now cheaper by about 10% for an American investor. So you can see why it's now looking more attractive.

Let's look at it from a company profitability perspective. BHP last year earned revenue of about USD$15.9 billion for exporting its iron ore. Once again, at an exchange rate of 80 cents, that equates to about AUD$19.9 billion. Roll the clock forward, at 72 cents—look at the increase in revenue. It goes up to $22.1 billion. So no change to volume of iron ore sold, no change to the price that they're getting—purely because the currency has fallen, we're getting an uplift of around 11% in revenues.

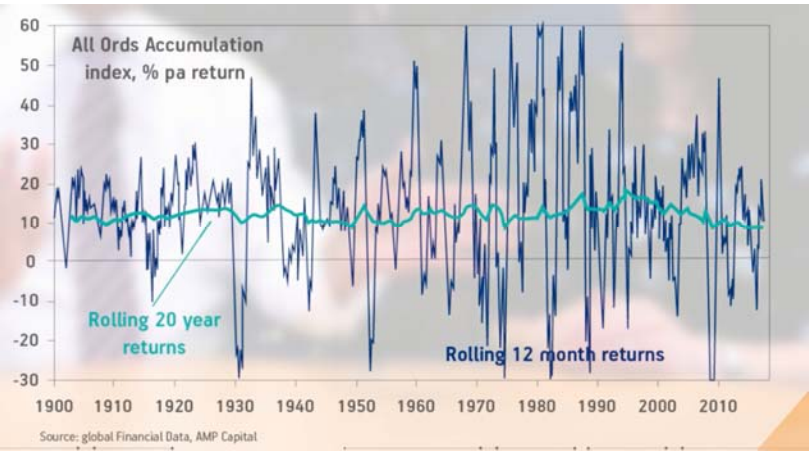
So while a lower currency obviously makes overseas trips more expensive, our members should take some comfort from the fact that their super funds are probably benefitting.

VP: So can we look forward to the share market breaking more records?

JP: Frankly, I'm a bit surprised that we're at record levels at the moment around the world. When the US Central Bank is tightening rates and taking US dollars out of the market, it's usually bad for share markets. We have seen some impacts of this, particularly on countries like Turkey and Argentina which are really in crisis mode because they are heavy borrowers of US dollars.

That hasn't impacted the rest of the world yet, but I don't know how long that's going to last. I'm expecting, while the Central Bank continues to tighten rates, we're going to see some more short-term volatility. But that shouldn't come as a surprise. This is a feature of financial markets throughout history.

Let me look at one of my favourite graphs. Here is a graph showing 12-month rolling returns of the Australian market over the last century. It's a pretty scary picture, right? There’s a lot of volatility there, and indeed, you have to empathise with members who need to sell shares for their living expenses, etc. That would be a concern and that's why we do suggest to our members to seek advice. However, let's look at that graph another way—rolling 20-year returns. Look how smooth that line becomes.



So in answer to your question, over the long term, yes, I do expect markets to grind higher and I do expect them to reach new records. But that's over the long term. That's what superannuation is all about, it's staying the course.

VP: Thanks for your time, John. If you have any questions for John, or feedback for us, please email **superinformed@unisuper.com.au**. Thanks for watching.